State of California
Office of the Attorney General
XAVIER BECERRA
ATTORNEY GENERAL

August 6, 2020

VIA ELECTRONIC SUBMISSION
U.S. Department of Labor, EBSA
Office of Exemption Determinations
200 Constitution Avenue NW, Suite 400
Washington, DC 20210

RE: ZRIN 1210-ZA29 - Improving Investment Advice for Workers & Retirees

Ladies and Gentlemen:

The undersigned Attorneys General of California, Connecticut, the District of Columbia, Illinois, Iowa, Maryland, Minnesota, New York, and Oregon write to comment on the Department's above-referenced proposed regulation and its reinstatement of the 1975 five-part test for fiduciary status. The Department's actions threaten the financial future of millions of Americans. They wrongly permit many financial advisers to avoid fiduciary responsibility altogether. And they allow the retirement account advisers that ERISA requires to act as fiduciaries to maintain harmful conflicts of interest.

The Department should withdraw this regulatory package and focus instead on a set of rules that truly protects retirement savers, rather than condone conflict-ridden business practices that erode the financial security of hardworking Americans.

At the very least, the Department should extend the comment period for this proposal to 90 days. The existing 30-day period is unreasonably short, especially as the nation grapples with the disruptions of the COVID-19 pandemic. The Department has been working on regulating investment advice for over a decade, and has previously afforded 90-day comment periods for proposals on this topic. In addition, a comment period of 60 or more days is consistent with executive orders governing the rulemaking process at Executive Branch agencies.[1]

I. LEGISLATIVE AND MARKET BACKGROUND

When Congress enacted ERISA in 1974, one of its main purposes was to increase the level of protection provided to retirement savers. Congress was particularly concerned that

[1] *See* Executive Order 12866, Regulatory Planning and Review, § 6(a) (Sept. 30, 1993) and Executive Order 13563, Improving Regulation and Regulatory Review, § 2(b) (Jan. 18, 2011).

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disclosure alone did not adequately protect retirement assets, and that fiduciary protections were required.[2]

The need for heightened protection for retirement accounts has only grown since ERISA was enacted. Today, individually-directed retirement plans such as 401(k)s and IRAs dominate the retirement landscape, and more complex and risky financial products have entered the marketplace. This means that individuals must make increasingly difficult investment decisions when navigating the financial marketplace. And the stakes are huge: as of March 31, 2020, American retirement savers held an estimated $9.5 trillion in IRA accounts and $7.9 trillion in employer-sponsored defined contribution plans.[3]

Against this backdrop, it is unsurprising that many retirement savers seek professional advice. It is equally unsurprising that many financial firms hold themselves out as trusted financial advisers to individual investors, inducing the reasonable expectation that those firms act in investors' best interests.[4] Much of the revenue these firms generate from retirement accounts comes from conflicted forms of compensation, such as 12b-1 fees, markups and markdowns, and revenue sharing payments. The firms in turn may incentivize their salespeople with conflict-generating differential compensation. These conflicts impose substantial costs on investors, especially as the impact of these costs compounds over the long time horizon of retirement investors. Numerous studies, including the Department's own research, show that conflicted advice costs retirement investors tens of billions of dollars annually.[5]

The Department correctly recognized the impact and significance of these costs in its Fiduciary Rule rulemaking process, and little has changed in the market since 2016. Yet the

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[2] *See* S. REP. NO. 93-127 at 4840-41 & 4847 (1973); H.R. REP. NO. 93-533 at 4641-42 & 4645-46 (1973); H.R. CONF. REP. NO. 93-1280 (1974), *as reprinted in* 1974 U.S.C.C.A.N. 5038, 5186.

[3] Investment Company Institute, *Retirement Assets Total $28.7 Trillion in First Quarter 2020* (June 17, 2020), https://www.ici.org/research/stats/retirement/ret_20_q1.

[4] *See, e.g.*, Angela A. Hung et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* 109-111 (2008), http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf (describing broker advertising and widespread mistaken impressions about broker and investment adviser standards of conduct).

[5] In its April 2016 regulatory impact analysis, the Department evaluated the best available, peer reviewed research to estimate that "underperformance associated with conflicts of interest – in the mutual fund segment alone – could cost IRA investors between $95 billion and $189 billion over the next 10 years and between $202 billion and $404 billion over the next 20 years." The Department cautioned that these expected losses "represent only a portion of what retirement investors stand to lose as a result of adviser conflicts" due to a lack of transparency into the revenue streams received by financial firms for conflicted advice. *See* U.S. Dep't of Labor, *Regulating Advice Markets – Regulatory Impact Analysis for Final Rule and Exemptions* (2016), at 158 & 162-63. The research also is specifically limited to the roughly 43% of IRA assets held in mutual funds (*see supra*, n. 3), and does not include the trillions of dollars of assets held in employer-sponsored plans.

Department's new proposal says nothing about those costs. Instead, it appears designed to protect the conflicted revenue streams that are so costly to retirement investors, rather than protect the hard-earned retirement savings of ordinary Americans.

II. THE REINSTATED FIVE-PART TEST CONTINUES TO MAKE IT TOO EASY FOR FIRMS AND ADVISERS TO AVOID FIDUCIARY STATUS

We oppose the Department's decision to reinstate the 1975 five-part regulatory definition of fiduciary investment advice.

First, under this obsolete test, most of the investment advice retirement savers receive would not be held to a fiduciary standard at all. The fiduciary investment advice definition requires that advice be given on both a regular basis and pursuant to a mutual agreement that the advice will be a primary basis for investment decisions. These requirements make it far too easy to avoid fiduciary standards.

Financial institutions such as broker-dealers and insurance companies could continue to avoid fiduciary requirements under the pretext that the transaction-specific advice they offer is episodic and therefore not provided on a regular basis. For example, the recommendation by a financial institution of a menu of investment options for a plan could continue to be considered a one-time advice event to a plan, even though plan participants as a group will regularly make selections from the menu. This leaves financial institutions free to stack the deck in their own favor and against the interests of retirement savers, by presenting choices that generate revenue for the company at the expense of investors.

Financial institutions of all types could also continue to use fine print to disclaim a mutual agreement that the advice will serve as a primary basis for investment decisions, even as they market themselves as trusted advisors, and establish a reasonable but false expectation in retirement savers that the firm places the saver's interests first.

Second, these requirements are inconsistent with the statutory definition of investment advice. Under the ERISA statute, a person is an investment advice fiduciary if he or she "renders investment advice for a fee or other compensation, *direct or indirect*, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so."[6] ERISA was enacted in order to achieve "broadly protective purposes," and it "commodiously imposed fiduciary standards on persons whose actions affect the amount of benefits retirement plan participants will receive."[7] To be consistent with the language and purposes of ERISA, the Department should not define "investment advice fiduciary" in a way that excludes the most important financial decisions that impact "the amount of benefits" in retirement savers' accounts.

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[6] 29 U.S.C. § 1002(21)(A)(ii); 26 U.S.C. § 4975(e)(3)(ii) (emphasis added).

[7] *John Hancock Mut. Life. Ins. Co. v. Harris Trust & Sav. Bank*, 510 U.S. 86, 96 (1993).

Third, the Department's decision to apply the five-part test to rollover advice does not meaningfully improve matters.[8] Previously, under the 2005 Deseret advisory opinion, rollover advice was not subject to the five-part test and was not generally subject to a fiduciary standard.[9] The Department suggests the adoption of the five-part test for rollover advice offers significant additional protection for investors. It does not.

This change in guidance offers little in practice to protect investors given the holes in the five-part test. Unless an investor is rolling over into a relationship with an investment adviser – already subject to fiduciary standards under the Investment Advisers Act – rollovers will seldom if ever be subject to fiduciary standards. If anything, the proposed change risks creating the mistaken impression that rollovers are now protected.

Instead of reinstating the five-part test, the Department should examine what changes are necessary to better protect retirement savers. We urge the Department to withdraw the final rule reinstating the five-part test, and formulate a definition of investment advice fiduciary that encompasses all the advisory services and transactions in which retirement savers reasonably rely on those who hold themselves out as trusted advisors.

III. THE PROPOSED PROHIBITED TRANSACTION EXEMPTION IS NOT PROTECTIVE OF RETIREMENT SAVERS

The Department has also proposed a new prohibited transaction exemption ("PTE") that would expressly allow investment advice fiduciaries to receive such conflicted forms of compensation as "commissions, 12b-1 fees, trailing commissions, sales loads, mark-ups and mark-downs, and revenue sharing payments from investment providers or third parties."[10] It permits ERISA fiduciaries to maintain these conflicts of interest provided that they, among other things, abide by a "best interest" standard analogous to the standard of the U.S. Securities and Exchange Commission's ("SEC") new Regulation Best Interest ("Reg BI"). The proposed PTE should be rejected.

First, the Department offers no investor protection rationale for the PTE. Rather, the Department asserts that permitting conflicted compensation practices would improve "flexibility" in retail investment markets. But the Department has offered no analysis or discussion of how existing prohibitions limit access to advice valuable to investors, as opposed to limiting conflicts lucrative to industry. Given the multitude of non-conflicted options

[8] What's more, the Department expressly states that a one-time recommendation to rollover into an annuity will not necessarily be protected. *See* Improving Investment Advice for Workers & Retirees, 85 Fed. Reg. 40,834, 40,840 (July 7, 2020) ("Release"). Yet annuities are complex financial instruments that investors rarely understand, and which very frequently pay some of the highest commissions and have the lowest sales conduct standards of any retirement product. Rollovers to annuity products should especially be subject to fiduciary standards.

[9] U.S. Dep't of Labor Op. No. 2005-23A (Dec. 7, 2005) (*withdrawn as of* Jun. 29, 2020).

[10] Release at 40,836.

available to investors in a diverse and competitive industry, there is no reason to believe that permitting such conflicts would benefit investors. Ensuring that those who hold themselves out as fiduciaries act as such is not "inflexible" – it is essential to meeting investors' reasonable expectations and protecting their retirement accounts.

Second, while the Department's proposed exemption sets out a standard similar to that contained in Reg BI, there is an important difference between Reg BI and the PTE. While Reg BI is itself inadequate to protect investors, at least there the SEC articulated that enhanced investor protection was a goal of the rule, and Reg BI does not diminish broker-dealer obligations beneath their existing suitability requirements. By contrast, the Department has not claimed that the PTE would enhance investor protections.

To the contrary, the PTE would expressly weaken investor protections. In particular, the PTE would allow those relatively few sellers of retirement investments who fail to avail themselves of the five-part test's loopholes to escape any meaningful requirement to avoid conflicts of interest. The PTE would instead largely subject them to the standard articulated in Reg BI. While that standard is presently ill-defined, it indisputably is less protective than a fiduciary standard, and it affords the financial industry wide latitude to decide for itself what "best interest" means in practice.[11] At the very least, if the Department is contemplating adopting a standard similar to Reg BI, it should wait to see how Reg BI is implemented, and for data to develop as to the degree to which it may be protective of investors or costly to them.

Third, the proposed PTE places considerable emphasis on disclosure to purportedly protect retirement savers from conflicts of interest. This is inconsistent with Congressional intent. In passing ERISA, Congress specifically found that disclosure was insufficient protection for retirement savers in the absence of fiduciary protections.[12] The proposed PTE is also inconsistent with the Department's statutory authority to promulgate exemptions from ERISA fiduciary requirements. The Department is only authorized to establish exemptions if they are "(1) administratively feasible, (2) in the interests of the plan and of its participants and beneficiaries, and (3) protective of the rights of participants and beneficiaries of such plan."[13] The exemption's reliance on disclosure is at odds with the statutory mandate to protect the rights and interests of retirement savers.

Fourth, the PTE contains a particularly troubling disclosure requirement. It requires that firms disclose that they are fiduciaries, while simultaneously exempting firms from critical

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[11] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33,318, 33,462-33,467.

[12] *See* S. REP. NO. 93-127 at 4840-41; H.R. REP. NO. 93-533 at 4641-42 (finding that a disclosure-based regulatory system for retirement investing "is weak in its limited disclosure requirements and wholly lacking in substantive fiduciary standards. Its chief procedural weakness can be found in its reliance upon the initiative of the individual employee to police the management of his plan.").

[13] 29 U.S.C. § 1108(a); 26 U.S.C. § 4975(c)(2).

conflict prohibitions that are definitional to being a fiduciary. The Department claims that this disclosure "is intended to ensure the fiduciary nature of the relationship is clear to investors." But in fact, the result of such a disclosure would be the exact opposite of the Department's stated intent. Requiring a disclosure of fiduciary status, while exempting firms from the most important requirements stemming from that status, is fundamentally confusing and misleading.

Fifth, the PTE relies on conflict mitigation provisions that fail to protect retirement savers. The Department provides no meaningful guidance on what type of conflict mitigation is required. The analogous Reg BI context offers little additional guidance. There, the SEC has offered nothing firm other than specifying that product-specific sales contests are no longer allowed. The PTE would appear to give firms free rein to create compensation incentives that encourage recommendations that pay them more even when there are better available alternatives for the investor. This includes production incentives that encourage rollovers, even though such a significant transaction might not be in a saver's best interest. In short, the mitigation provisions of the proposal signal to the industry that it remains free to set up incentive structures that will deprive retirement savers of the impartial advice they deserve and reasonably expect.

Sixth, whatever weak protections the exemption offers will be unenforceable for IRA investors. The Department is clear that the proposed PTE does not create any private right of action. Nor can the Department itself enforce the standard.[14] Firms would therefore have little motivation to comply with the PTE with respect to IRA accounts, further exacerbating the conflicts of interest arising from rollover recommendations.

Seventh, the Department claims that the proposed PTE is "aligned" with state regulations, including the Massachusetts broker fiduciary standard, in the sense that they all include conduct standards. But the Massachusetts conduct standard is a higher one: it prohibits brokers in a fiduciary relationship from considering their own interests.[15] The proposed PTE, on the other hand, opens the door to precisely that conduct. The Department's analysis, if adopted in a final rule, will only exacerbate investor confusion in this area.

IV. CONCLUSION

The Department claims that its regulatory package will "improve investment advice for workers and retirees," and that this scheme will preserve investors' choices. However, it is not in investors' interests to allow financial firms to induce trust while selling expensive products that are remunerative to themselves, costly to investors, and contrary to fiduciary principles. This proposal elevates the interests of broker-dealers, insurance companies, and other financial firms at the expense of retirement savers, and deprives them of protections Congress legislated. The combined effect of this proposal and Reg BI – in which the SEC declined to create a fiduciary standard for retail investment advice by broker-dealers – is a substantial weakening of

[14] *See* 29 U.S.C. § 1132.

[15] *See* 950 MASS. CODE REGS. 12.207.

investor protections for ordinary Americans. We urge the Department to withdraw the proposal, or at a minimum, extend the comment period to a more reasonable length of 90 days.

Sincerely,

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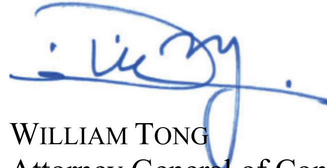

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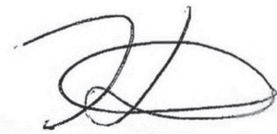

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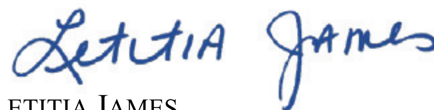

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